



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

Number: **201202038**  
Release Date: 1/13/2012

Date: October 6, 2011

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filed:

Tax Years:

UIL: 501.03-05; 501.32-00; 501.33-00

Dear :

This is our final determination that you do not qualify for exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(3). Recently, we sent you a letter in response to your application that proposed an adverse determination. The letter explained the facts, law and rationale, and gave you 30 days to file a protest. Since we did not receive a protest within the requisite 30 days, the proposed adverse determination is now final.

Since you do not qualify for exemption as an organization described in Code section 501(c)(3), donors may not deduct contributions to you under Code section 170. You must file Federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose*, and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, you should follow the instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

In accordance with Code section 6104(c), we will notify the appropriate State officials of our determination by sending them a copy of this final letter and the proposed adverse letter. You should contact your State officials if you have any questions about how this determination may affect your State responsibilities and requirements.

Letter 4038 (CG) (11-2005)  
Catalog Number 47632S

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter. If you have any questions about your Federal income tax status and responsibilities, please contact IRS Customer Service at 1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Lois Lerner  
Director, Exempt Organizations

Enclosure  
Notice 437  
Redacted Proposed Adverse Determination Letter  
Redacted Final Adverse Determination Letter

Letter 4038(CG) (11-2005)  
Catalog Number 476328



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

Date: August 9, 2011

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

**LEGEND:**

B = President of applicant  
G = Contracted for-profit  
H = Contracted for-profit  
J = Related for-profit company  
K = For-profit company  
V = State  
W = State  
x = Date

**UIL INDEX:**

501.03.05  
501.32-00  
501.33-00

Dear :

We have considered your application for recognition of exemption from federal income tax under Internal Revenue Code section 501(a). Based on the information provided, we have concluded that you do not qualify for exemption under Code section 501(c)(3). The basis for our conclusion is set forth below.

**Issues:**

1. Are you formed to obtain grants primarily benefitting B, through the for-profit company J? Yes, for the reasons given below.
2. Will you operate in a commercial, non-exempt manner? Yes, for the reasons given below.

**Facts:**

Your president B, the owner of for-profit J was approached by company G about opportunities to pursue grant funding. G is a professional grant writing company based

in state V.

The purpose of for-profit company J is to service and repair all heating, ventilation, and air conditioning (HVAC) equipment.

Company G explained to individual B that grants were available for businesses, but to secure the largest grants, individual B would need to create a nonprofit corporation. Individual B, with company G's assistance, incorporated you on date x in state V. Although you were formed in State V, you are actually operating in State W, and you are registered with state W as a foreign corporation.

You were working with company G regarding your formation, but your account was then taken over by company H. You stated company G "was talking to us about getting loans or grants for our existing company," for-profit J. You paid approximately \$2000 to company G. You stated company H "ran some kind of report that got back 250 foundations that would fund a company with programs that we wanted to do for kids." Company H told you that 98% of grants are given to non-profit companies, and in order to get funding for what you wanted to do, you would have to "open a 501(c)(3) company." You said an individual working for company H "sold" you a package which included setting up the company with the state and filing Form 1023 for tax exemption. You signed a contract with company H and paid them over \$7000 to prepare and file your Articles of Incorporation, Bylaws, and your application for exemption, as well as provide paralegal services. The contract had an accompanying statement:

I hereby understand and agree that company H cannot provide me with tax advice. I further agree that I am not applying for non-profit status for the purposes of a tax shelter or tax avoidance purposes. I understand and agree that these services I am purchasing are not consumer purchases regulated under state/federal consumer fraud statutes nor are these services a product/service that can be returned for a refund. Therefore, all sales are final. I also understand and agree that company H is not responsible for any illegal acts, misuse, or abuse of the corporation to be formed on my behalf.

Between all of the contracts signed with companies G and H, you and for-profit J were promised almost \$1,000,000.

Initially you did not have Bylaws and stated "the Bylaws are being written by company G." You later submitted a copy of said Bylaws.

Your governing body initially consisted of four related individuals: Individual B, his wife, his daughter, and his mother. You later added four additional board members and said one of the related board members resigned due to health reasons.

You will provide vocational education in the field of HVAC to high school students and adults through after-school and night classes. HVAC students will have hands-on, on-

the-job training as well as classroom training. The students will create projects from sheet metal fabrication, welding of rod iron, and architecture blueprinting. You will also offer classes for stained glass fabrication, woodwork, floral arrangements, photography, pottery, leather crafts, graphic arts, and tee-shirt design printing for grammar school to junior high school-aged children.

There are 4 specific 6 week, 20 hour training classes. The students must complete all 24 weeks to complete the class. You will pay the trainees minimum wage during the training period. They will receive a Certificate for Completion for the class. They are then referred to a local placement services for jobs that may be available in the area. However, as long as you have funding and there is a need, the individual in your program will continue to work for you. You further stated you "need to take for-profit company J to the next level" and to do that you will need 10 full-time employees. You have a shop and are ready to go. You also said "expectations are that approximately 50% of students completing the training programs will be hired by for-profit company J." You later contradicted your prior statement and said you only expect 50% of the students completing the first class will be hired by for-profit company J, for a total of 3 individuals. You further asserted referrals will be accepted from other businesses for those in need of training, which will be provided by you at no charge to the student.

In B's daily work with for-profit company J, he "comes across many community residents that are in need of services, but who cannot afford them. These people will be referred to you for assistance." You said "all services performed by the [you] will be free of charge to those in need, after an evaluation has been done of their circumstances."

Your projected percent of time and grant funds used for your initial activities are estimated as follows:

Vocational Education Program – Training Individuals in the field of (HVAC)	50% of your time and 45.5% of funds
Youth Arts and Crafts – Teaching various Crafting techniques to students	40% of your time and 28.5% of funds
Other Projects – Monthly craft shows and Festivals	10% of your time and 26% of funds

Company H helped you by typing the answers to our inquiry letters. You communicated by telephone with company H regarding our inquiries and they were the ones who actually typed the responses. However, you responded to one of our inquiry letters twice. It appears one of the responses was prepared by company H and one was prepared by you. The response you prepared stated 50% of the grant funding you receive will go back to for-profit company J for equipment, trucks, inventory, certified training, and to hire and train employees. The other response, which appeared to be prepared by company H, indicated there will be no commingling of funds "between our

for-profit and non-profit companies."

Your original proposed budgets included about \$600,000 per year in gifts, grants and contributions received for each of the first three years of operation. The expenses you included totaled less than \$13,000 in the first year and approximately \$83,000 for each of the following two years. One version of your two submitted responses included a revised first year budget that showed about \$800,000 in revenue from grants. The expenses listed also totaled almost \$800,000. The largest expenses were for advertising and marketing, equipment, and salaries for officers, teachers, and trainees.

The revised budget appears to have been prepared by company H. The response which appears to have been prepared by you included, rather than specific budgets, a statement that you "have projects coming up for non-profit in excess of 1.5 million over the next 2 years."

You are in the startup phase and no salaries or expenses are paid to any officer or employee at this time. Once actual funding is received and a "true budget" can be formed, officers will be paid a salary for "running the company." You were told by G or H that you could take salaries of up to \$50,000 per year, but for now everyone is a volunteer. Each of your board members will devote a minimum of 20 hours per week working for you. Although it's not set, pending funding, you will pay each of these directors a fair and reasonable salary for their work. You will start with an annual salary of \$20,000 each.

Until a separate facility is secured with grant funding you stated you will use "a portion of the offices we now rent," referring to the offices of for-profit company J. You stated when the programs get under way "[you will] pay a portion of that rent, based on how much room is required for the training classes." You said the for-profit company J currently pays \$1428 per month for rent. You later stated the portion of rent you intend to pay is \$1200 per month, which is 84% of the total rent.

### **Law**

Section 501(c)(3) of the Internal Revenue Code provides, in part, for the exemption from federal income tax of organizations organized and operated exclusively for charitable, religious or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)1 of the federal Tax Regulations provides that in order for an organization to be exempt under section 501(c)(3) of the Code it must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational or operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(2) of the regulations provides an organization is not operated

exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an exempt organization must serve a public rather than a private interest. The organization must demonstrate that it is not organized or operated to benefit private interests such as "designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests." Thus, if an organization is operated to benefit private interests rather than for public purposes, or is operated so that there is prohibited inurement of earnings to the benefit of private shareholders or individuals, it may not retain its exempt status.

Rev. Rul. 73-127, 1973-1 C.B. 221, states that an organization was formed to operate a retail grocery store to sell food to residents of a poverty area at prices substantially lower than those charged by competing grocery stores, to provide free grocery delivery service to residents who need it, and to provide job training for unemployed residents. The store's gross earnings are used principally to pay salaries and other customary operating expenses incurred in the operation of a retail grocery store and to expand the operations of the store. A trainee receives a small salary during the training period. The organization does not plan for the majority of the trainees to continue as its employees. Thus, it is concluded that operation of the store and operation of the training program are two distinct purposes and since the former purpose is not a recognized charitable purpose, the organization is not organized and operated exclusively for charitable purposes and the organization does not qualify for recognition of exemption from federal income tax under section 501(c)(3) of the Code.

Rev. Rul. 73-128, 1973-1 C.B. 222, states an organization was formed to provide vocational training and guidance to non-skilled persons who are unable to find employment. The organization operates a number of community programs including classes in remedial reading and language skills, general counseling services, and job training programs. The organization recruits residents of a particular economically depressed community and who are unemployed or under-employed, and it provides them with new skills through on-the-job training while they are earning a living. Any income resulting from the organization's manufacturing operation is used to finance the organization's other community service activities. Accordingly, it is held that the organization's activities are charitable and educational and, since it otherwise qualifies for exemption, it is held that the organization is exempt from federal income tax under section 501(c)(3) of the Code.

Better Business Bureau of Washington, D.C., Inc v. United States, 326 U. S. 279 (1945), the Supreme Court of the United States interpreted the requirement in section 501(c)(3) that an organization be "operated exclusively" by indicating that an organization must be devoted to exempt purposes exclusively. This plainly means that the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number and importance of truly exempt purposes.

Leon A. Beechly Fund v. Commissioner, 35 T.C. 490 (1960) held that inurement occurred when an organization entered a transaction to benefit the *stockholders* of a particular business corporation, not to benefit the charity, even though the corporation suffered no financial loss. Where an exempt organization engages in a transaction with an insider and there is a *purpose* to benefit the insider rather than the organization, inurement occurs even though the transaction ultimately proves profitable for the exempt organization. *The test is not ultimate profit or loss but whether, at every stage of the transaction, those controlling the organization guarded its interests and dealt with related parties at arm's-length.*

In B. S. W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978), it was stated that free or below cost service is only one of several factors to consider in determining commerciality. Others include the particular manner in which the organization's activities are conducted, the commercial hue of those activities, and the existence and amount of annual or accumulated profits. All of these must be considered, for no single factor alone is determinative. The Court concluded that the petitioner is not an organization described in section 501(c)(3) because its primary purpose is neither educational, scientific, nor charitable, but rather commercial.

In International Postgraduate Medical Foundation v. Commissioner, TCM 1989-36 (1989), the Tax Court considered the qualification for exemption under section 501(c)(3) of the Code of a nonprofit corporation that conducted continuing medical education tours. The petitioner had three trustees. Mr. Helin, who was a shareholder and the president of H & C Tours, a for profit travel agency. Mr. Regan, an attorney, and a third director who was ill and did not participate. Mr. Helin served as executive director. The petitioner used H & C Tours exclusively for all travel arrangements. There is no evidence that the petitioner ever sought a competitive bid. The Court found that when a for-profit organization benefits substantially from the manner in which the activities of a related organization are carried on, the latter organization is not operated exclusively for exempt purposes within the meaning of section 501(c)(3) even if it furthers other exempt purposes.

In Living Faith Inc. v. Commissioner, 60 T.C.M., 710, 713 (1990), aff'd 950 F. 2d 365 (Cir. 1991) the court said that the activities were conducted as a business and the organization was in direct competition with other restaurants and health food stores; thus it did not qualify for exemption under Section 501(c)(3).

### **Application of Law**

You are not described in section 501(c)(3) of the Code because you are not operated exclusively for religious, charitable, or other purposes specified in the statute, and your net earnings inure to the benefit of private individuals.

Although you meet the organizational test, you do not satisfy the requirements of



section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations because you do not meet the operational test.

You are not "operated exclusively for one or more exempt purposes" as set forth in section 1.501(c)(3)-1(c)(2) of the regulations because your net earnings inure to the benefit of for-profit company J and therefore, J's shareholders. The facts show that your president and founder, B, is also the owner of J. As a result of your activities and grant funding, J is receiving substantial private benefit in the form of a percentage of the grant funds intended for you. J will use these funds to increase revenue and grow its business. Thus, as a result of J's relationship with you, J receives the benefit of increased revenue. This situation leads to inurement of earnings accruing to B through J. Although you submitted conflicting information regarding whether or not for-profit company J will receive a percentage of the grant funds, it is evident that the entire reason you were formed was to secure grant funding and otherwise benefit the commercial operations of for-profit company J.

You are not operating exclusively for exempt purposes as described in Section 1.501(c)(3)-1(d)(1)(ii) of the Income Tax Regulations because you serve private interests, including benefiting the persons who created you. As explained above, the fact that a percentage of the grant funding intended for you will go to J, clearly shows that your activities substantially serve private interests. Moreover, since your president and founder is also the owner of J, your activities directly benefit the person who created you.

Based upon your stated activities, you plan to use grant money to provide facility upgrades and equipment to for-profit company J, which is owned by individual B. Also, you intend to pay a substantial portion of the rent for the facility that you share with for-profit company J. Payments made for the benefit of a for-profit company through grant moneys constitute inurement of earnings and precludes exemption under Section 501(c)(3) of the Code.

The provision of practical, on-the-job vocational training may constitute an exempt educational activity under Section 501(c)(3) of the Code; however, your operations are similar to the retail grocery store operations carried on by the organization in Rev. Rul. 73-127, *supra*. By contrast, your operations are unlike those of the organization in Rev. Rul. 73-128, *supra*, whose activities were primarily educational. Your provision of HVAC training to individuals, some of which will become employees of individual B's for-profit company J, does not exclusively further one of the exempt purposes included in section 501(c)(3) of the Code. By training employees that will be hired by J, you are expending funds for training that would otherwise have to be paid by J if it were not for you. This provides substantial private benefit to J. Since J is owned by your president, this training of J's employees constitutes inurement.

You are similar to the organization in Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U. S. 279 (1945), in that you are not "operated exclusively" for

exempt purposes. Although you may have some charitable activities, you are substantially involved in furthering the private interests of your president and founder B, through his for-profit company J. Only a portion of grant funding will be available for your use because a percentage of grant funds will go directly to J. Like the organization in the court case, this single nonexempt purpose destroys your claim for exemption under section 501(c)(3) of the Code.

You are like the organization in Leon A. Beeghly Fund v. Commissioner, 35 T.C. 490 (1960). While it is true that receiving grant funding ultimately proves profitable to you, it is obvious you have a purpose to benefit an insider, B. The fact that a percentage of grant money is forwarded on to the related for-profit company shows that you are not guarding your own interests at every stage of the transaction as described in the above court case. All of this is substantiated by B's statement that "I need to take my company (referring to for-profit J) to the next level."

You have indicated that you plan to provide free HVAC services to low-income individuals. As in the above-cited case of B. S. W. Group, Inc. v. Commissioner, free or below cost service is only one of several factors to consider in making a determination on commerciality. Others include the particular manner in which the organization's activities are conducted and the commercial hue of those activities. As you are operating the exact same program as the current for-profit HVAC business, your primary purpose is not educational, scientific, or charitable, but rather commercial. You serve the same purpose, provide the same educational services, and operate out of the exact same facility as for-profit J. In fact the two entities are indistinguishable. These factors show you are operating in a commercial manner.

You are similar to the organization in International Postgraduate Medical Foundation v. Commissioner, TCM 1989-36 (1989) in that you have a substantial purpose of benefiting a related for-profit company. Because you were formed for the substantial purpose of enabling for-profit company J to receive grant funding, J benefits substantially from the manner in which your activities are carried on. Therefore, you are not operated exclusively for exempt purposes as described in section 501(c)(3).

You are planning to cover the cost of HVAC services provided by for-profit company J to individuals that cannot afford them through grants received by you. This simply expands the client base of the related for-profit and provides it with customers that would otherwise not be able to pay. Therefore, you are causing grants to be used for a non-exempt purpose for the direct benefit of the for-profit company owned by your founder, B. As in Living Faith Inc. v. Commissioner, supra, your activities are in direct competition with other HVAC businesses, which causes you to be disqualified for exemption under Section 501(c)(3).

**Applicant's Position:**

You stated your main purpose and activity is not to teach young students about the HVAC industry, but to teach them a variety of craft projects. You stated your second program is to offer High School students and adults who are interested in learning a trade in the HVAC industry. The program is free of charge to students and you supply all materials needed. You stated that for-profit company J intends to hire 3 individuals from the class and they do not intend to conduct anymore hiring from your training program.

**Service's Response to Applicant's Position:**

While you are providing some educational activities, your overall purpose is to secure grant funding to further benefit your president and founder, B and his for-profit business J. Any true 501(c)(3) activities are incidental to the excessive private benefit to B. Since B is an insider, this constitutes inurement, and the presence of any amount of inurement precludes qualification for exemption regardless of any qualifying purposes or activities.

It is also important to note that your president, B, applied for exemption because his for-profit company J was solicited by company G. Company G explained to individual B that grants were available for businesses, but to secure the largest grants, B would need to create a nonprofit corporation. This further solidifies the fact that your purpose of formation was to benefit B and his for-profit company J.

**Conclusion:**

The facts show that you have a substantial nonexempt purpose and were formed to obtain grants primarily benefitting B, through the for-profit company J. This constitutes substantial private benefit and inurement. Furthermore, a substantial portion of your activities include operating in a commercial manner that is indistinguishable from for-profit J. Accordingly, you are not operated exclusively for purposes described in IRC section 501(c)(3) and you do not qualify for exemption.

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination. If your statement does not provide a basis to reconsider our determination, we will forward your case to our Appeals Office. You can find more information about the role of the Appeals Office in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*.

An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you during the appeal process. If you want

representation during the appeal process, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. You can find more information about representation in Publication 947, *Practice Before the IRS and Power of Attorney*. All forms and publications mentioned in this letter can be found at [www.irs.gov](http://www.irs.gov), Forms and Publications.

If you do not file a protest within 30 days, you will not be able to file a suit for declaratory judgment in court because the Internal Revenue Service (IRS) will consider the failure to appeal as a failure to exhaust available administrative remedies. Code section 7428(b)(2) provides, in part, that a declaratory judgment or decree shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted all of the administrative remedies available to it within the IRS.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848, and any supporting documents to the applicable address:

Mail to:

Internal Revenue Service  
EO Determinations Quality Assurance  
P.O. Box 2508  
Room 7-008  
Cincinnati, OH 45201

Deliver to:

Internal Revenue Service  
EO Determinations Quality Assurance  
550 Main Street  
Room 7-008  
Cincinnati, OH 45202

You may fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Lois Lerner  
Director, Exempt Organizations

Enclosure: Publication 892